

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Baca Analyst: Colin Stevens Bill Number: SB 37

Related Bills: See prior analysis Telephone: 845-3036 Amended Date: February 9, 1999

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Exclusion/Gain From Sale of Capital Assets Held For 5 Years/ Minimum Tax/Exempts For First Income Year New Corporations

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED DECEMBER 7, 1999, STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would exclude from income any gain from the sale or exchange of a capital asset held by a taxpayer that is purchased on or after January 1, 2001, and held for more than five years.

Under the B&CTL only, this bill would exempt a qualified new corporation (QNC) that is incorporated on or after January 1, 2000, from prepaying the minimum franchise tax to the Secretary Of State.

Each of these provisions will be discussed separately.

This bill also would make a change to the General Fund revenue forecast. This provision will be discussed only as it relates to the Franchise Tax Board.

SUMMARY OF AMENDMENT

The February 9, 1999, amendments:

Refer to provisions in federal law describing property that qualifies for a reduced tax rate on capital assets held for over five years, to specify that only assets that qualify for capital gains tax rate reduction under federal law would qualify for the 100% exclusion provided under this bill, and that only assets purchased on or after January 1, 2001, held for more than five years and sold after January 1, 2006, would qualify for the exclusion.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald Goldberg

3/1/1999

Specify that QNCs would receive an exemption from paying the minimum franchise tax to the Secretary of State (SOS) upon incorporation. This would apply to income years beginning on or after January 1, 2000.

Provide that an additional tax of \$800 would be payable if a corporation paid no amount at the time of filing with the SOS, but later was found to have gross receipts that exceed \$1 million in its first income year.

Make the operation of the minimum franchise tax exemption for QNCs inoperative in any year that the Department of Finance could not make certain certifications regarding the level of General Fund forecasted revenue for the implementation of the additional vehicle license fee reduction.

Other than the amendments described above, the resolution of certain policy and implementation concerns identified in the department's analysis of the bill as introduced December 7, 1998, the addition of new implementation concerns and the revised revenue estimate, the department's analysis of the bill as introduced December 7, 1998, still applies. The applicable implementation considerations are restated below.

EFFECTIVE DATE

The provision affecting qualified capital gains would apply to taxable or income years beginning on or after January 1, 2006. The minimum franchise tax provision would apply to income years beginning on or after January 1, 2000.

COMBINED REVENUE IMPACT

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of SB 37 As Amended 2/9/99 [\$ In Millions]				
Exemption from Prepayment of Minimum Tax				
	1999-00	2000-01	2001-02	
	(\$3)	(\$5)	(\$6)	
Exclusion of Qualified Five-Year Gain				
2004-05	2005-06	2006-07	2007-08	2008-09
(\$50)	(\$200)	(\$500)	(\$700)	(\$950)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

CAPITAL GAINS

Implementation Considerations

It is unclear what portion of capital gains would be excluded if an asset held for five years had improvements made at some time during the holding period.

For example, if a building purchased for \$200,000 and held for five years was remodeled for \$800,000 during the third year of the holding period and sold for \$2 million after the fifth year, it is unclear whether the full \$1 million would be exempt from gain, or only the \$200,000 initially invested five years ago.

This bill could provide an incentive for taxpayers to classify business assets (i.e., Section 1231 assets) as capital assets to engage in activities that have the effect of converting ordinary income into capital gains in order to take advantage of the exclusion. Without further rules provided in the bill, it could require extensive audit activity for department staff to determine whether such conversion is occurring.

The bill does not specify whether part-year and nonresidents who pay California tax would exclude from income the entire amount of the capital gain or only the percentage of income attributable to California. Further clarification would assist department staff in implementing the bill.

Technical Considerations

The author has indicated that this bill should, by reference to federal provisions, provide an exclusion from income only for assets purchased on or after January 1, 2001, and sold during taxable or income years beginning on or after January 1, 2006. Various technical amendments are needed to accomplish this objective. Department staff is available to work with the author's staff to write such language.

Author's staff has indicated that neither revenue reductions provided by this bill should be taken into account in calculating future VLF reductions. Currently, the language regarding the VLF would apply only to the prepayment of the minimum tax. However, since the final tax reduction for the VLF allowed under Section 10754 of the Revenue and Taxation Code is scheduled to occur in 2004, it is unlikely that the provisions of the capital gains exclusion would impact the calculation of the VLF.

Tax Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Exclusion of Qualified Five-Year Gain [\$ In Millions]				
2004-05	2005-06	2006-07	2007-08	2008-09
(\$50)	(\$200)	(\$500)	(\$700)	(\$950)

The initial two fiscal year impacts above reflect a behavioral impact for taxpayers that would hold assets longer than otherwise to qualify for the proposed exclusion (the 2005-06 estimate includes \$40 million of static impact). The tax impact of excluding qualified five-year gain would increase incrementally until equilibrium is reached in 20-25 years. The equilibrium impact is projected to be on the order of \$1.6 billion at 1999 levels.

Tax Revenue Discussion

The number of capital gain transactions (as defined), the amount of excluded qualified five-year gains and effective tax rates of taxpayers with such transactions would determine the revenue impact of this provision.

The revenue impact of the capital gain exclusion was based on capital asset sample data (1996 base). Revenue losses are estimated as the difference between tax liabilities under current and proposed laws. Projected realized capital gains are tracked by vintages of purchase date. Each taxpayer's separate capital gain transactions, reduced taxable income, any capital loss limitation, and marginal tax rate were used to derive an average tax rate to apply to projected qualified five-year gains. Results from sample data were weighted statistically to the population. Losses for 1996 were projected to later years using the most recent capital gain growth rates as provided by the Department of Finance through 2001 and an assumed 7% annual rate thereafter. The corporate impact is included in the estimate above and was estimated to be 5% to 10% of the PIT impact.

It is likely some taxpayers would decide to hold assets for a longer period to avail themselves of the exclusion proposed in this bill. A taxpayer otherwise motivated to sell an asset may decide to delay the sale to meet the required five year holding period and qualify for the 100% exclusion of qualified five-year gains. The additional revenue loss from this predictable behavioral response is based on departmental data regarding capital asset holding periods.

MINIMUM TAX EXEMPTION

Implementation Considerations

This provision would become inoperative in any year the DOF is unable to certify that sufficient funds would be available to meet certain targets required to reduce the VLF were it not for the operation of this bill. Current law requires the DOF to make the certification on September 1 for the following fiscal year. This provision could cause some implementation problems in preparing tax booklets for printing and completing programming necessary to process tax returns.

Technical Considerations

The provision impacting the minimum franchise tax specifies two operative dates. The operative dates should be clarified to indicate that the amendments to subdivision (f) would apply the amendments made to paragraph (2) of subdivision (b) and that the amendments made to subdivision (g) would apply to all portions of Section 23221 except for paragraph (2) of subdivision (b).

Tax Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Exemption from Prepayment of Minimum Tax [\$ In Millions]		
1999-00	2000-01	2001-02
(\$3)	(\$5)	(\$6)

Tax Revenue Discussion

The number of qualified new corporations (as defined) otherwise subject to a prepayment of minimum franchise tax of \$300 to the Secretary of State would determine the revenue impact of this provision. For 2000, the number of qualified new incorporations (domestic and foreign) is projected to be 18,000.